IN THE

United States Court Of Appeals

FOR THE NINTH CIRCUIT

No. 21184

In the Matter of

FIKE PLUMBING & HEATING CO., INC.,

Bankrupt.

TUCSON HOUSE CONSTRUCTION COMPANY AND RORERT E. MCKEE GENERAL CONTRACTOR, INC.,

Appellants,

v.

WALTER E. FULFORD, as Trustee in Bankruptcy of FIKE PLUMBING & HEATING CO., INC.,

Appellee.

On Appeal From the United States District Court for the District of Arizona

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REPLY BRIEF OF APPELLANTS

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INTRODUCTION

The principal arguments made by the appellee have been anticipated and fully answered in our main brief. We shall confine this reply to a discussion of selected matters called into question by appellee's brief.

ARGUMENT

1. Appellee's contention that the setoff is invalid for the reason that "Fike owed McKee no debt" is untenable.

Appellants have presented four reasons for their contention that Fike is obligated to McKee as a result of its default on the Lincoln Hospital project (Appellants' Br. 11-15). It is understandable that the trustee would like to convince the Court that Fike did not owe a debt to McKee, but the "shot-gun" approach employed by the trustee detracts from his argument which, like a bat in the twilight, disappears in the sunshine of actual facts.

The trustee apparently concedes that if McKee was bound to Fike's suppliers, then Fike did owe McKee a debt (Appellee's Br. 12-13). The facts clearly show, as pointed out in our opening brief, that McKee was obligated to Fike's suppliers, and was subject to a direct suit by these suppliers, who were third party benefiiciaries under McKee's payment bond to John C. Lincoln Hospital, Inc. Since McKee has in fact paid these suppliers (T.I. 39, 80), there also exists an obligation on the part of Fike to reimburse McKee.

Taking the trustee's argument at face value, one would be led to believe that McKee would never have a provable claim against Fike, even if it were unable to prove its right of set-off. The trustee apparently takes this position because McKee has ahead of it in the chain of liability a surety which has the "ability to respond", and against whom McKee would have a right to cross-claim (Appellee's Br. 12-13).

Is it the trustee's contention that an obligor's liability should depend on whether or not there is a surety on the line which is "able to respond"? What would be the trustee's position if Reliance was not "able to respond"? Presumably, under the trustee's version of the law, McKee would have a provable claim in that situation.

The trustee asserts that any debt owed by Fike to McKee would have to exist "at the time of its bankruptcy". The origin of this proposition is a general statement in *Collier*, which is subordinate to the general rule that provable claims only may be set-off against an obligation owing to the estate of a bankrupt. It is clear that the requirement of provability is satisfied by provability at the time the setoff is claimed. 9 Am. Jur.2d, Bankruptcy, §510;[1] *Norfolk and W. R. Co. v. Graham* (4th Cir. 1906) 145 F. 809; *Morgan v. Wordell* (1901) 178 Mass. 350, 59 N.E. 1037.[2] Indeed, even the maturity of a claim at the time of bankruptcy is not essential to its availability as a setoff. *New York County National Bank v. Massey* (1904) 192 U.S. 138, 24 Sup. Ct. 199, 48 L. ed. 380; *Frank v. Mercantile National Bank* (1905) 182 N. Y. 264, 74 N.E. 841.

The trustee speaks of McKee's "contingent liability" (Appellee's Br. 13), and clearly the law is to the effect that contingent debts and contingent contractual liabilities of the bankrupt may be proved. 4 Collier, Bankruptcy, 14th Ed., Para. 68.11, pages 760-761;[3] Bankruptcy Act Section 63a(8) (U.S.C. §103a(8)). Since McKee has paid Fike's suppliers (T.I 39, 80) because of its obligation to do so, its contingent obligation has come into existence; and Fike's corresponding obligation to McKee may be available as a setoff under the laws cited above, even if it

[1] "It is not required that the claim should have been provable in time to have been proved in the bankruptcy proceeding."

[2] In the words of Mr. Justice Holmes, "'Provable' means provable in its nature at the time when the set-off is claimed, not provable in the pending bankruptcy proceedings."

[3] "Thus where the bankrupt and another are joint obligors, and the other joint obligor pays the claim in full after bankruptcy, such obligor may set off the bankrupt's portion of the obligation which he paid against a debt that the obligor owed to the bankrupt estate. *This may be placed on the basis that although rights are adjusted as of the date of bankruptcy, the obligor then had a contingent debt or liability as to the payment of the bankrupt's* half of the *obligation which was provable under §63a(8), and which was subsequently liquidated by payment.*" (Emphasis added).

can be successfully argued that Fike's obligation to McKee was contingent only at the time of its bankruptcy.

The trustee would treat McKee as a secondary debtor, to be classified as a surety for the purposes of his argument. The fallacy of his reasoning is immediately apparent. While it is true that Fike was a primary debtor in the sense that it was contractually bound to its suppliers, when Fike filed bankruptcy it was no longer bound, or able, to pay anything. The trustee's argument and reasoning would lead one to the conclusion that Fike never entered into a subcontract with McKee, and that Respondents' Exhibit 8 never existed. The record in this case proves otherwise.

It is interesting to note that one of the cases upon which the trustee relies, *Griffith v. Stucker* (1913) 91 Kan. 47, 136 P. 937, involved a situation where the assignee of laborers and materialmen having claims against the bankrupt subcontractor had brought an action not only against the bankrupt subcontractor's surety, but also against the general contractor. It is unfortunate that the trustee did not choose to include the preceding portion of the paragraph he quoted from in that case.[4]

Thus the reasoning of the trustee's cited case seems to contradict his contention that "there was obviously no privity of contract" between McKee and Fike's suppliers. We contend that the *Griffith* case is authority for our contention that there was privity between McKee and Fike's suppliers because of the obligation owed by McKee to the suppliers by virtue of McKee's payment bond running to Lincoln Hospital, and its contract with Lincoln Hospital. The fact that McKee might be able to seek indemnification from

[4] "It is said that the surety company can be liable only on two conditions: First, that some privity existed between Stucker [the general contractor] and the laborers and materialmen because of some duty or obligation in the premises owed by him to them; and, second, that the object of the bond was to benefit the laborers and materialmen directly and not merely incidentally. Both conditions are clearly present. Stucker was obligated by law and by his contract with the City to provide security for the payment of the claims of Lightfoot Bros.' laborers and materialmen."

Reliance does not eliminate McKee's obligation on the Lincoln Hospital project. Surely, liability on a contractual obligation is not dependent upon whether or not there is a surety "able to respond".

The trustee's apparent view of the holding in *Keefer v. Lavender* (1952) 74 Ariz. 24, 243 P.2d 457 (Appellee's Br. 11), is not well-taken. The Keefer case involved an action to foreclose a mechanic's lien, and the Supreme Court of Arizona held that a personal judgment against the owner of the property on which a lien is claimed may not be rendered unless there is a contractual relation between the lienor and the owner. The *Keefer* case has no application to our fact situation. The record in the case at bar shows that there was a contract in existence between Fike and McKee (Respondents' Exhibit 8). The trustee's analogy from the Keefer case that Fike was not obligated to McKee because Fike was not McKee's agent, can best be classified as shabby reasoning, and is so obviusly devoid of merit that it needs no further elaboration.

The trustee's argument regarding Section 57(i) of the Bankruptcy Act is irrelevant to the issues of this case. Section 57(i) is concerned with proofs of claim of sureties, endorsers, guarantors, and other persons secondarily liable. 3 Collier, Bankruptcy, 14th Ed., Para. 57.21 pages 331-332. We could not be more in agreement with the trustee in regard to the law he has stated as it relates to a *surety proving its claim,* but his attempt to classify MeKee as a secondary debtor is a failure. The entire discussion involving Section 57(i) is apparently designed as a smoke screen to the issues of this case, and is indicative of the trustee's frantic attempts to cloud the obvious fact that McKee has a provable claim against the bankrupt estate under Section 63a, and the fact that its rights in no way are, or have ever been claimed to be, based upon Section 57(i).

What is the trustee really trying to say by this argument? It's simply this: A surety or secondary debtor, who must under Section 57(i) *prove his claim* in the name of the primary creditor,

is not entitled to set-off any claim it has against the bankrupt. None of the cases cited by the trustee support this contention. The fact that the bankrupt owes the obligation to reimburse the surety or secondary debtor is the legal basis for the mutuality necessary to allow the accomplishment of the setoff. That it could be otherwise would not only be unequitable but absurd. How else could Hanover in the *Sherman* case (infra) have accomplished its right of set-off. Hanover was a surety who had paid Sherman's materialmen under its bond obligation; and Section 57(i) was never mentioned in the decision nor did it have any bearing on Hanover's right of set-off.

2. Appellee's contention that Reliance had no right to compel McKee to effect its right of set-off is contradictory to the privilege given Reliance under the laws of the State of Arizona.

It must be remembered that the rights of Reliance are not at issue in this case. It was only over the objection of appellants that the matters concerning Reliance were injected in this case by the trustee's attorney, in what was an obvious attempt to artificially color the case in his favor. The real issue is not whether Reliance could compel McKee to make the setoff, but *whether McKee had the right to effect the setoff.*

Rliance's statutory right under Arizona Revised Statutes §12-1641 was advanced solely as an additional reason for proving Fike's obligation to McKee as a result of its default on the Lincoln Hospital project. Clearly this statute allows Reliance to force McKee to bring an action against Fike for its contract deficiencies on the Lincoln Hospital project. This is true irrespective of McKee's right to effect a setoff. Despite the trustee's argument that the *Pain v. Packard* doctrine is not a favorite of the law, it must be remembered that *it is the law of the State of Arizona.*

The trustee has attempted to prove that Reliance did not comply with the provisions of the above statute by claiming that a "notice in writing" was never given by Reliance to McKee. What better proof have we than Trustee's Exhibit 10? This docu-

ment was a "notice in writing" directed to McKee from Reliance, and while it does not require that McKee bring an action upon the contract, it is also true that "the law does not require futile things", as so eruditely pointed out by the trustee in his brief (Appellee's Br. 26). Since Fike was already insolvent at the time Trustee's Exhibit 10 was written, it would have been foolish for Reliance to require McKee to go through "an idle and fruitless ceremony." Therefore, Reliance directed McKee to effect its setoff "forthwith."[5]

The trustee's "legal disability" argument in relation to the applicability of Arizona's *Pain v. Packard* statute is unsound. That portion of the statute relating to the obligee's "legal disability" refers to the remedy available to the surety in the event such an "action upon the contract" is not brought. Since no action was brought, for the reasons given above, no permission was needed from the Bankruptcy Court to effect the setoff under Section 68 of the Bankruptcy Act.

The trustee has attempted to limit Reliance's right to require the setoff as arising solely out of its right of "subrogation". This is no doubt based upon the use of the word "subrogation" by Reliance in Trustee's Exhibit 10 (See Appellee's Br. 23-24). The word "subrogation" has a variety of meanings. It has been described as an equitable remedy or a right implied by operation of law. It occurs as a matter of right, independent of agreement. Black's Law Dictionary, 4th ed., pages 1595-1596.

It should be obvious that the word "subrogation" used in the context of Trustee's Exhibit 10 would not automatically exclude

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[5]Trustee's Exhibit 10 reads as follows: "Reliance claims that McKee should make payment of Fike's obligations for labor and materials on the Lincoln Hospital project and should *forthwith* offset the moneys due under Fike's contract on the Tucson House project, to the extent available, against its claim against Fike on the Lincoln Hospital project." (Emphasis added). In view of the use of the word "forthwith", we are somewhat perplexed over the trustee's citation of two Indiana decisions having to do with the leaving out of the word "forthwith" (Appellee's Br. 25).

Reliance's statutory rights under Arizona Revised Statutes §12-1641. This is a case of substance prevailing over form, and certainly the trustee does not claim that Reliance has waived its statutory right by virtue of its use of the word "subrogation". Indeed, Reliance's right of subrogation has never arisen in this case, at least in regard to the monies in question; and as previously pointed out, Reliance is not a party to this lawsuit.

One blatant error made by the trustee must be corrected at this time. The trustee has stated on at least two occasions in his brief (Appellee's Br. 6, 23) that Mr. Haug, admittedly the attorney for Reliance throughout the period involved in this litigation, was also representing McKee at the time Trustee's Exhibit 10 was prepared. There is absolutely no evidence in the record to prove this statement, and in fact, at the time Trustee's Exhibit 10 was prepared, McKee was represented by capable independent counsel.[6] For the trustee, at this late date, to accuse counsel for appellants of a gross conflict of interest is the ultimate in attempting to shift the Court's attention from the true issues of this case.

3. Appellee's argument concerning the setoff of parnership debts ignores the fact that McKee's debt, if not individually owed, was owed jointly and severally.

The trustee has attempted to dismiss appellants' argument that a joint venture was not actually formed, with the unwarranted charge that appellants' argument "borders on the criminal." (Appellee's Br. 16). Instead of devoting attention to the legal issues involved, the trustee has chosen to use this personal attack to cover up the weakness of his legal argument.

That the "joint venture agreement" was entered into to give Robbins and Schiff the requisite identity of interest for FHA purposes has been previously explained (Appellants' Br. 15-19).

[6] Eugene R. Smith, Senior partner in the firm of Kemp, Smith, Brown, Goggin & White of El Paso, Texas, specializing in fidelity and surety matters.

The FHA did not require that a joint venture be formed. Such a method was chosen by McKee and its counsel in order to make Robbins and Schiff jointly liable along with McKee for the payment of any subcontracts, including Fike's, on the Tucson House project. This had the effect of giving Robbins and Schiff a sufficient identity of interest for them to obtain a builder's and sponsor's profit and risk fee of 10% and make the project feasible (T.I 54-57). But there was no doubt in anyone's mind that McKee was to do the actual contracting work for the beneficial owners, Robbins and Schiff.

McKee agreed to indemnify fully Robbins and Schiff from any losses which they might suffer as a result of the "joint venture", and from the evidence it is clear that Robbins and Schiff obtained no ownership interest in the construction contract. In fact, the monies in question due to Fike were clearly to come from McKee's payment as spelled out in Trustee's Exhibit 2 (T.I 57, 61-62).

Appellants quite agree with the quote cited by the trustee from the case of *Mercer v. Vinson* (1959) 85 Ariz. 280, 287, 336 P.2d 854 (Appellee's Br. 16). It has always been the appellants' position that the facts disclose that a true joint venture was never formed.

Even if it be assumed, for the sake of argument, that a joint venture was formed, it is clearly the law that McKee's obligation is joint and several (Appellants' Br. 21). Indeed, the trustee has never argued nor cited any cases for the proposition that McKee's debt was not a joint and several debt. Instead the trustee has apparently elected to skirt this vital issue by citing several cases which hold that a joint debt cannot be set-off against a several or individual debt.

It is understandable that the trustee would like to change the issues in this case in order that the law he has cited may become applicable. Appellants have cited many cases for the proposition

that a joint and several debt may be set-off against an individual debt (Appellants' Br. 22-23). Appellants have also cited a recent bankruptcy case wherein a joint and several debt was permitted to be set-off against an individual debt, the exact situation which now confronts us. *In re Sherman Plastering Co.* (2d Cir. 1965) 346 F.2d 492. The trustee, on the other hand, has not cited a sigle case, bankruptcy or otherwise, which declares that a joint and several debt may not be set-off against an individual debt, or, to be more specific, which holds that a joint and several debt due a bankrupt from a partnership or joint venture may not be set-off against a debt due from the bankrupt to an individual member of such partnership or joint venture.

The *Sherman* case involves a fact situation very similar to the case at bar. As the diagram on page 27 of Appellants' brief graphically demonstrates, Hanover owed its debt to the bankrupt Sherman jointly and severally. McKee likewise, if a joint venture was actually formed, is obligated to the bankrupt Fike jointly and severally. Hanover also owned its debt from Sherman individually, and similarly, MceKe owns its debt from Fike on the Lincoln Hospital project individually. The trustee does not take issue with the *Sherman* decision, which holds that a joint and several debt may be set-off against an individual debt. Therefore it is difficult to follow the trustee's logic in asserting that a setoff cannot be allowed McKee.

It is also interesting to note that the case of *In re Neaderthal* (2 Cir. 1915) 225 Fed. 38, formerly cited by the trustee in support of his argument (R. 47), and mentioned in the quote on page 19 of appellee's brief, was specifically overruled by the Second Circuit in the *Sherman* case to the extent that it be interpreted as disallowing a setoff in a situation amounting to the "reciprocal" of the facts in the *Sherman* case. The trustee has apparently abandoned the *Neaderthal* case, but still clings to his case authorities which stand for the proposition that a joint debt

(but not a joint and several debt) cannot be setoff against a separate debt (Appellee's Br. 17).

4. Appellee's trust fund theory is without factual or legal support and is not relevant in any event.

Appellants' position in regard to the appellee's trust fund argument has been previously set forth (Appellants' Br. 28-32). This is the trustee's second-string argument for denying appellants' setoff. It should be obvious, however, that if McKee has a right of set-off, there should be no question that it would be allowed to mechanically accomplish the setoff, and the trustee's "trust theory" becomes an irrelevant truism.

It is contended that a trust fund did exist herein by virtue of the bankrupt's filing a Notice and Claim of Lien. Yet this erroneously presupposes that a valid lien was created in favor of Fike. Thus, the very foundation of the trustee's argument is based upon a non-existent presupposition—a validly perfected lien—and the argument must fall of its own weight.

The cases the trustee cites to support his trust theory deal with states having mandatory retention statutes, and they presuppose a valid lien. Indeed, it is difficult to conceive of a case which would allow a trust fund to be esrablished on the basis of an invalid lien. The trust theory in the instant case is further irrelevent for the reason that McKee was not obligated to pay Fike out of the retention monies it received.

It must also be pointed out that the trustee has elected to go outside the record with his statement that McKee knew of the existence of the lien "all along" (Appellee's Br. 21). This statement is untrue even by the trustee's own version of the facts (Appellee's Br. 4). The uncontroverted evidence shows that neither Tucson Title Insurance Company nor McKee became aware of the lien's exisrence until December, 1964 (T.1 10, 120-123; Respondents' Exhibit 11).

5. Interest and attorney's fees.

The trustee has apparently missed the point of appellants' argument in regard to the interest allowed by the Referee. Appellants do not challenge the awarding of interest per se, only the date from which the interest was awarded.

Clearly it would have been impossible for appellants to determine accurately the amount which might eventually have to be spent on warranty items on the Tucson House project at the time final payment was received from the owners on December 11, 1964. It defies all logic for the trustee to claim that he is entitled to interest from the period thirty days after the receipt of final payment from the owners, when the one-year warranty did not commence until after the *completed contract*, which would include the receipt of final payment from the owners.

In regard to the matter of attorney's fees, appellants are willing to concede that in the Federal Court no evidence is required as to the quantum of the fee when the fee is set by the trial judge who hears the case. Appellants persist in their argument, however, that the Referee in Bankruptcy was without jurisdiction to make such an award under our particular fact situation (Appellants' Br. 39-40). If, however, this Court decides that attorney's fees may be awarded, we would remind the Court that they may modify the attorney's fee award in any manner [*Curran v. Security Insurance Company* (D. C. Ark. 1961) 195 F. Supp. 562], and further that appellants, in the event they are successful in this appeal, also claim attorney's fees upon the same basis as the trustee (Trustee's Exhibit 3; Appellee's Br. 3).

CONCLUSION

Based on the foregoing, and on the arguments contained in appellants' opening Brief, it is respectfully submitted that the District Court's order affirming the Referee's turnover order be reversed, that McKee's right of set-off be established, that the warranty period be established as expiring not prior to December 11, 1965, that the trustee be denied attorney's fees, and that the cause be remanded with instructions to fix the exact amount owing to the trustee.

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I certify that in connection with the preparation of this Brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Brief is in full compliance with those Rules.

William F. Haug